

Smuggled Smokes: California Closes in on New York

By Michael LaFaive, Todd Nesbit PhD and Michael Lucci

Policymakers the world over have used taxes to pursue a variety of goals. One obvious use is to raise revenues to pay for some service or asset. Another is to curb or end behavior that is considered a “sin” by some, hence the moniker “sin tax.” This is often applied to products that officials believe the public should consume less of: Sugary snacks, alcohol and cigarettes come to mind.

It is the latter of these products and their association with tax evasion and avoidance (what we dub “smuggling”) and other unintended consequences that we have studied for years. In our most recent review of the data, we find that illicit activity associated with cigarettes nationwide is still a problem, and in some states, a growing one. In fact, California climbed five spots year-over-year in our ranking of states with the most smuggling to take the No. 2 position overall — only behind perennial leader New York state. High-tax states need to reduce their cigarette taxes to reduce interstate smuggling.

Cigarette excise tax rates vary widely across states, from \$0.17 per pack in Missouri to \$4.35 per pack in New York and Connecticut, creating an obvious profit opportunity in smuggling. Local cigarette excise taxes further exacerbate these tax differentials. Policymakers in some high-tax states have increasingly relied on cigarette excise tax hikes to fill revenue gaps. But high cigarette taxes put health and revenue policy goals at odds with one another and in contradiction with the principles of sound taxation and budgeting. When policymakers pursue high taxes to achieve health goals, the result is an unstable revenue stream and increased smuggling.

Punitive taxes in high-tax states are not stable sources of revenue. The history of cigarette tax hikes across the states shows a predictable revenue pattern: A spike in revenues in the front years after a tax hike is followed by a significant decline in revenue over time. Policymakers should not rely on cigarette taxes for ongoing government services, and they should be wary of the public health effects of creating a lucrative black market for cigarettes.

Background

In the early 1990s, the state of Michigan hiked cigarette taxes by 200 percent, or 50 cents per pack, from 25 cents to 75 cents. The tax-induced price hike set off alarm bells for consumers and criminals alike to search for alternatives to both save and make money. A big smuggling bust in 2000 of a [criminal cell running smokes](#) between North Carolina and Michigan grabbed the attention of the Mackinac Center for Public Policy. Its leadership decided thereafter to try to estimate the degree to which cigarette smuggling was occurring in the Great Lake State.

The Mackinac Center partnered up with the Tax Foundation of Washington, D.C. — which had just completed [California-specific research on the cigarette tax and smuggling](#) issue. Together, we have updated the results of those initial estimates. The most recent estimates use excise tax data through 2017 and inform a statistical model we made.

The model compares legal-paid sales of cigarettes in each state with smoking rates in each state. The difference between the number of cigarettes smoked and volume of legal sales needs to be explained and we — as with other scholars — do so by pointing to smuggling. We also estimate possible illicit imports from Mexico and exports to Canada.

Estimates

Through 2017, our model reports that the number one (inbound) smuggling state in the union is — once again — New York, at 55.4 percent. In other words, of all the cigarettes consumed in the Empire State in 2017 (legal and illegal), more than 55 percent were a function of tax evasion and avoidance. New York is followed by California (44.5 percent), which raised its cigarette excise tax by \$2.00 per pack in 2017. ([See interactive map of state smuggling rates here.](#))

While the Golden State is No. 2 in our rankings, it is No. 1 in the nation for gross revenue lost to smuggling. That is, if there were no cigarette tax evasion or avoidance to speak of, California's treasury would receive \$1.9 billion more in cigarette excise tax revenue every year than it does now. New York is second in that category at \$1.4 billion.

New York and California are followed by the states of Washington (42.8 percent), New Mexico (40.8 percent) and Arizona (39.3 percent) in their smuggling rate. Two additional points are worth making here. First, Washington's smuggling rank may change dramatically in two years, as neighboring Oregon is now considering a cigarette tax increase of \$2.00 per pack. If adopted, that hike will make the trip from Washington to Oregon for smokes [less attractive in border counties](#), as Oregon's new rate would be slightly above Washington's. In addition, while our model attributes to Mexico some of the smuggling into New Mexico and Arizona, some portion of it may be passing through bonded warehouses instead.

Bonded warehouses are essentially intermediate stations for cigarettes coming from or going to different countries. It is all too easy to divert some portion of the goods before they are taxed. In 2018 two men were convicted for doing just that at the Port of Los Angeles, where cigarettes marked for export were instead channeled, untaxed, to local retail stores.

The state that sees the largest percentage of cigarettes taken from its borders is New Hampshire, at 65 percent. That means that for every 100 cigarettes smoked there, an additional 65 are moved elsewhere due to smuggling, typically to a neighboring state. The top five states are rounded out by Delaware (40.6 percent); Idaho (26.8 percent); Virginia (24.2 percent) and Wyoming (22.4 percent). These states all share at least one of two qualities: They have low cigarette tax rates in absolute terms, or their tax rates are significantly lower than nearby and easily accessible neighboring states.

While these top states generate revenue from cigarette sales exported elsewhere, Indiana has the second highest (behind New Hampshire) net positive revenue impact from cigarettes smuggled elsewhere. We estimate that the state received about \$64 million in tax revenue that would otherwise not have accrued to its treasury absent illicit traffic into other states, such as Michigan. Indiana's excise tax rate, at almost \$1.00 a pack, is less than half that of the Great Lake State and lower than neighboring Illinois, Ohio, and even tobacco state Kentucky. Moreover, Michigan and Illinois are currently contemplating new cigarette tax increases which would accrue further fiscal benefits to Indiana.

Excise taxes matter greatly to border county sales, especially in relatively populated areas. For our 2008 smuggling study, [we obtained sales data from a large wholesaler](#) in the Midwest. This allowed us to examine how retailers in Michigan responded to a 79 percent increase in the Indiana cigarette excise tax in 2007. Our analysis discovered that sales to Michigan retailers in counties bordering Indiana leapt by 58 percent in the three months before Indiana's higher rate took effect and stayed above 50 percent

higher afterward. Why? Retailers knew that smokes in Indiana were more expensive, making a run across the border more expensive.

Literature

Ours is far from the only scholarship on cigarette smuggling in North America. One of the authors (LaFaive) reviewed the literature for a 2016 study and counts 25 studies that reported some state or local smuggling rate. The clear majority of those seemed to show significant smuggling rates. In 2019, another cigarette smuggling paper was published in the journal *Public Finance Review*.

The PFR study, titled “Relative Tax Rates, Proximity, and Cigarette Tax Noncompliance: Evidence from a National Sample of Littered Cigarette Packs” is based on a collection of discarded cigarette packs from 38 states in 132 communities. The authors examined the tax stamps to determine where the packs came from. The authors determined that the average “noncompliance” rate nationwide is 21 percent. That is, 21 percent of the packs examined from a nationwide collection did not display the proper tax stamp, which would be evidence that all taxes due had been paid. The authors also note that even with additional tax hikes higher revenue would likely be generated in “virtually all areas in our study. ...”

“What if” Scenarios on Proposed Hikes

In addition to the estimates we can make for the effects of existing tax rates, our model can estimate the impact that *proposed* cigarette excise tax hikes will have on smuggling. We have already done this for six active proposals in five states.

- Legislation has been [introduced in Michigan](#) to hike the cigarette excise tax by \$1.50. We anticipate a hike of this size to kick the state’s smuggling rate from just under 21 percent to 34.4 percent of the total market.
- Gov. Jay Pritzker of Illinois had recommended a 32-cent increase per pack for cigarettes in Illinois from its current \$1.98, but just last week, the Senate president, John Cullerton, proposed a \$1.00 increase. Our estimates indicate that Gov. Pritzker’s tax increase would kick up smuggling from 17.2 percent of the market to 22.1 percent. The Senate president’s \$1.00 increase would increase the smuggling rate to 31.7 percent.
- Oregon’s current smuggling rate is relatively low at 4.4 percent, but that would leap under a \$2.00 increase (150-percent plus) in the cigarette tax rate to 38.4 percent of the total market.
- Nebraska is in the throes of a tax reform debate now that could include a 36-cent increase in the state excise tax on cigarettes to \$1.00. Doing so would take the state’s smuggling rate from nearly zero (0.67 percent outbound) to 6.9 percent.
- Gov. Gina Raimondo of Rhode Island has included in her most recent budget proposal (released in January) a 25-cent increase in the cigarette excise tax to \$4.50 per pack. This would raise the state’s smuggling rate from 31.2 percent to 38.1 percent.

Unlike the first “what-if” scenarios above, we expect Rhode Island to experience a net revenue loss from this tax hike of approximately \$5.9 million as a direct result of tax evasion and avoidance.

Other Unintended Consequences

Cigarette smuggling is not the only unintended consequence of high excise taxes. Other unwanted activities involving illicit activities in the cigarette trade include different types of theft — often brazen — and public corruption, risks of violence and more.

Just two weeks ago, the Weatherford, Texas, police department caught burglars trying to steal cigarettes at a local retail store. A spokesman for the department told the press that about 90 percent of smash-and-grab incidents such as this one involve cigarettes because of their high value in the illicit market. Stolen smokes are often sold in Fort Worth.

In January an Ohio man was arraigned for his attempt to steal an entire truckload of cigarettes from a Cincinnati distributor. Stealing truckloads of cigarettes from distributors-wholesalers is not unheard of. Some trucks have even been hijacked out from underneath drivers in Michigan. One wholesaler in Detroit has had to take extreme security measures — including the use of a decoy truck and private security force — to safely guide his cigarette merchandise to its various destinations.

In December last year, an Independence, Missouri, retail store owner was robbed of cigarettes twice on the same day, with the thieves apparently making off with thousands of dollars in product. This was not even one of the most brazen thefts we've recorded.

As was the case during the Prohibition era, the attraction of easy money takes its toll on public safety officers. In the past we've been told of police officers arrested for their roles in smuggling contraband smokes, and of jail and prison guards smuggling cigarettes into the facility that employs them. One recent lesson in the difficulty of preventing smuggling is that some people find it very hard to kick the habit, causing them to engage in extreme behavior.

Last month a jail officer in Montgomery County, Ohio was fired for his role in smuggling cigarettes into the county jail. While smuggling contraband into jails is not unusual, it should raise questions about the plausibility of keeping illicit smokes out of a state with porous borders. It also highlights the difficulty of using price as a way to motivate people to quit smoking. The fired officer was apparently charging \$100 per pack. If \$100 per pack won't convince people to quit, what price will?

We could build walls of concrete and steel around New York, California, Michigan and turn them into police states and contraband of every sort would still get through. Prices would soar, but that wouldn't stub out all smoking. In fact, as in the era of alcohol Prohibition, the higher prices would only stimulate illicit suppliers and shift demand toward illicit markets and for products with greater potency.

States interested in lowering their high smuggling rates and other unintended consequences should consider — among other ideas — lowering their cigarette excise tax rates. It is arguably the most efficient way to thwart cigarette scofflaws large and small. And it is also would put those states better in line with the principles of tax neutrality and revenue stability.

Conclusion

With current tax gaps, politicians of every stripe are giving people incentives to save a buck by crossing borders in search of lower-priced tobacco products. Worse, they're announcing to the world's criminal

class that there is big money to be made engaging in large-scale, long distance and well-organized trafficking of illicit tobacco.

Our research, conducted over years and peer-reviewed by other scholars, shows a direct connection between high excise tax rates and smuggling. New York and California may lead the nation in packs of untaxed smokes, but they are far from alone. Recent scholarship unrelated to the Mackinac Center for Public Policy and Tax Foundation finds that nationwide average noncompliance with cigarette tax laws is high. That phenomenon, and other problems related to tax evasion and avoidance, will likely only get worse as states like Michigan, Oregon, Rhode Island and others continue to go to the cigarette excise tax well.

Instead of continuing to hike taxes, officials in high cigarette excise tax states ought to consider lowering them to narrow the gap between their states and lower-taxed ones.

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